

Internal Revenue Service
memorandum

CC:TL-N-509-91

Brl:MLTorri

date: NOV 28 1990

to: Special Trial Attorney, Cleveland

from: Assistant Chief Counsel (Tax Litigation)

CC:TL

subject: [REDACTED]

This is in response to your memorandum dated October 16, 1990, requesting tax litigation advice in the case captioned above, and confirms the telephone conferences between you and Mitzi L. Torri on November 15 and 20, 1990.

ISSUE

What is the proper methodology for computing the adjustment pursuant to I.R.C. § 481(a) resulting from a reduction in depreciable basis of assets to account for unrefunded contributions in aid of construction? 0167-0505; 0167-0700; 0481-0000.

CONCLUSION

The method used in the notice of deficiency is an incorrect method for making a "year of change" adjustment. In addition to the adjustment in the basis of the assets, a section 481 net adjustment to income is necessary to correct the distortion of income in the taxable years preceding the year of change which resulted from the overstatement of depreciation deductions.

FACTS

The taxpayer, [REDACTED], is a regulated public utility which receives a portion of the funding for extending main water and sewer lines from developers. These advances are refundable to the developer -- in whole or part -- if certain conditions are met, and actual repayment (supposing these conditions are met) may not be completed for more than 20 years. The taxpayer has treated these refundable advances as loans and, consequently, claims depreciation and investment tax credit on the property constructed with these funds. The Service, on the other hand, has taken the position that the funds represent contributions in aid of construction ("CIACs" or "advances") and,

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consequently, the taxpayer does not have basis in the assets constructed with such funds.

In the notice of deficiency to the taxpayer, the Service determined that the reduction of the taxpayer's basis (with a corresponding reduction in the depreciation deduction) constitutes a change in method of accounting to which the provisions of I.R.C. § 481 apply. However, the methodology used by the revenue agent in computing the deficiencies was: subtract from the adjusted basis (as computed by the taxpayer) the unrefunded advances as of the beginning of the year of change, and allow depreciation (using the taxpayer's chosen method and life) upon that "corrected" adjusted basis over the remaining life of the asset. That is, the revenue agent made only a section 1016 adjustment to basis and did not make any net adjustments to taxable income for the taxable years preceding the year of change, as required by section 481(a). In your memorandum you used the following hypothetical to illustrate the difference between the "proper" section 481 method and the statutory notice method:

Assume taxpayer placed an asset in service on 1/1 of year One, using a ten-year life, straight line method, and claiming a basis of \$[REDACTED]. In each of the first five years, taxpayer claimed a depreciation deduction of \$[REDACTED], and adjusted basis accordingly:

Year:	<u>One</u>	<u>Two</u>	<u>Three</u>	<u>Four</u>	<u>Five</u>
Orig./ Adjusted basis	\$ [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Less deprec.	- [REDACTED]	- [REDACTED]	- [REDACTED]	- [REDACTED]	- [REDACTED]
Adjusted basis	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]

In year Five the Service examines the taxpayer's return and determines that \$[REDACTED] in advances received by the taxpayer for construction of the asset are CIACs, and basis must be reduced accordingly. Taxpayer's "corrected" original basis is \$[REDACTED]. In the notice of deficiency, the basis adjustment is made in year Five, and adjustment is made to the depreciation deduction for year Five based on the "corrected" adjusted basis. Taxpayer will be allowed a reduced annual depreciation deduction based on the "corrected" adjusted basis:

Statutory Notice Method:

Original basis claimed	\$ [REDACTED]
Less:	
Depreciation claimed	[REDACTED]
Adjusted basis (per taxpayer)	[REDACTED]
Less:	
"Improper" original basis	[REDACTED]
Adjusted basis (corrected)	\$ [REDACTED]
Year Five adjustment:	
Claimed depreciation	\$ [REDACTED]
Less:	
Allowable depreciation	[REDACTED] *
Adjusted basis (corrected)	\$ [REDACTED]

*\$ [REDACTED] /six-year remaining life

The result, however, is significantly different if the "proper" section 481 method is used:

Section 481 Method:

In each of the first five taxable years, the taxpayer's depreciation deduction of \$ [REDACTED] was overstated by \$ [REDACTED]. The adjustment for year Five would be \$ [REDACTED], plus a positive net adjustment under section 481 of \$ [REDACTED], composed of the \$ [REDACTED] excess depreciation claimed in each of the preceding taxable years. Adjusted basis (corrected) would be \$ [REDACTED], for which the taxpayer will be allowed annual depreciation deductions of \$ [REDACTED] over the remaining life of the asset (five years).

Year:	<u>One</u>	<u>Two</u>	<u>Three</u>	<u>Four</u>	<u>Five</u>
Corrected orig./adjusted basis	\$ [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Less deprec.	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Adjusted basis (corrected)	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]

You question whether the method used in the statutory notice is (a) the correct method; (b) an incorrect method; or (c) one of the correct methods.

DISCUSSION

We agree with the position asserted in the notice of deficiency that the change in treatment of CIACs constitutes a change in the taxpayer's method of accounting. The change proposed by the Service is from inclusion of CIACs in depreciable basis to exclusion of CIACs from depreciable basis until such time that the taxpayer has actually refunded the advance to the developer. This represents a change in the treatment of a material item inasmuch as it involves the proper time for the inclusion of the item in income or the taking of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a).

While income for the year of change will be clearly reflected under the new method of accounting, unless some adjustment is made, taxable income in the preceding years will have been distorted by the excessive depreciation deductions claimed. In each of those years, the taxpayer's use of an erroneous method resulted in an overstated depreciation deduction, and consequently, taxable income was understated. The purpose of section 481 is to cure this distortion by requiring a net adjustment to taxable income in the year of change that restores to income the cumulative amounts of understatement in the preceding years.

Mechanically, section 481 takes a "let's pretend" approach, in which it is assumed that the taxpayer has used the permissible method (or the new method) of accounting every taxable year since year One. That is, taxable income for all taxable years prior to the year of change is computed under the new method. There will result a cumulative amount that will have been omitted from income in the preceding years or will be duplicated in income in later years. This amount represents the net adjustment, and will be a positive adjustment to taxable income in the year of change if the change in method results in an understatement of income in the preceding years, and will be a negative adjustment if the new method results in an overstatement of income in the preceding years.

If the purpose of the section 481 adjustment is to cure the distortion of income in the preceding taxable years, it is apparent that the method used in the statutory notice does not achieve this result. Thus, it is an incorrect method. The effective result of adjusting only the taxpayer's basis in the asset is an acceleration of depreciation and, hence, an understatement of income in the preceding taxable years. The method used not only fails to cure the distortion of income in the preceding years, but it also causes a distortion of income (an overstatement of taxable income) in the year of change and years following.

We recognize that there may be insufficient data available to compute a "proper" section 481 adjustment. Under these circumstances, reasonable estimates may be agreed upon between the Commissioner and the taxpayer. Section 481(c); Treas. Reg. § 1.481-5(a).

If you have further questions regarding this matter, please contact Mitzi L. Torri at FTS 566-3521.

MARLENE GROSS

By: Richard L. Carlisle
RICHARD L. CARLISLE
Senior Technician Reviewer
Branch No. 1
Tax Litigation Division